

MICHAEL J. MURPHY  
State Treasurer

Second Quarter 2004

# The QUARTERLY

Local Government Investment Pool

## The period of rising interest rates

### *Measured pace approach*

There was an air of rate-hike certainty even before the June 30 meeting when Federal Reserve policymakers raised interest rates a quarter point to 1.25 percent. The move was widely expected to create a smooth monetary policy transition in the financial markets.

Fed Chairman Alan Greenspan gave the market ample warning of a policy change prior to the rate hike announcement. The word "measured" was used in the FOMC statement to convey the Fed's intention of tightening in an orderly manner. It was considered assurance that it will act accordingly and give time for the market to adjust to subsequent policy revisions. This was somewhat of a departure from the manner in which previous rate hikes were announced; especially those in the early 1990s that roiled equity and bond markets globally. The Fed chairman clearly reiterated that "further increases can come at a *measured pace*,

inflation threat from a recovering economy.

While the committee perceived inflation to be a threat, they considered it still low enough to justify the "measured pace" language in their statement. In order for the Fed to maintain its flexibility it reiterated that "(it) will respond to changes in economic prospects as needed to fulfill (its) obligation to maintain price stability."

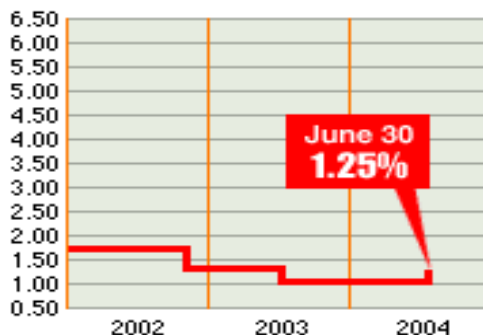
This qualifying statement was well-received by the market since it signifies the Fed's flexibility and resolve to contain inflation. The Fed is attempting to raise rates without economic disruption while fostering economic growth with minimal inflation worries.

### *Economic recovery: Is it also transitory?*

Job creation was very much the big story during the first half of 2004. There was a pick-up in hiring in all sectors of the economy. The pick-up could be attributed to both excess demand and the slowdown in the overall productivity numbers approaching secular growth trend. Construction, retail, and non-manufacturing services jobs all benefited from the renewed strength of the economy. The manufacturing sector also started to stop its overall decline in the second quarter. Consumer spending, business capital outlay, and the resilient housing market were the main drivers of the economy.

The hiring frenzy during the March-May period created an average of 304,000 jobs, but the jobs market experienced a brief slowdown as shown by the meager 112,000 jobs created in June. Consumer spending also cooled off, partly in response to higher gasoline prices which increased nearly 25 percent year-to-

### Fed funds rate



as long as inflation remains *relatively low*."

The hike, the first since May 2000, occurred when the committee members saw enough

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*continued on page 2*

## Market summary

*from page 1*

date. Market watchers named surging energy prices as the initial culprit, and the onset of summer (seasonal factors) as another reason for the weakening trend. Investors are quite confident that the weakness could be qualified as somewhat "transitory." Most firms agreed that there is a strong demand on the basis of the pickup in their business activities. Business capital spending has seen some growth compared to its very weak performance last year. Equipment and software spending increased significantly to offset a fall in non-residential structures outlay.

Sustainable growth seems very likely; however, a slowdown in productivity could derail the gains both in hiring and capital investments. A slowdown in productivity tips the balance between output and cost. A combination of slower productivity and higher inflation rate could stoke the Fed's concern about being behind the curve. Rising inflation is a big concern as unfilled orders are rising at a 7 percent clip, signaling excess demand. The economy did not experience this last quarter and the Fed even noted that there was still 'slack' in resource utilization.

Investors will be watching subsequent interest rate hikes and the corresponding language used by the Fed. More data will be needed to correctly assess the state of the country's economic situation, since business cycles suffer from ebb and flow. The Fed at its June 30 meeting acknowledged it needs to reverse its policy of monetary accommodation by bringing the funds rate back up to neutral. The market now expects a series of rate hikes in subsequent Fed meetings.

## The bond market

The market had anticipated, and priced in, the Fed's quarter-point rate hike. The yield on the two-year note fell to 2.67 percent after rising to a high of 2.94 percent two weeks before the meeting. The market appeared to be pleased that the Fed maintained its gradualist approach to reduce excess monetary accommodation. The market priced a 2-2.25

percent fed funds rate by end-2004 as reflected by fed fund futures, due to concerns of higher inflation. Higher energy prices, lower productivity, and higher labor costs were the main factors that triggered a belief the Fed might raise rates in each remaining FOMC meeting of 2004.

Further out the curve, the benchmark 10-year Treasury note also gained a point after the announcement, pushing yields down to 4.59 percent. The market reaction in both the short and long-end saw a steepening curve as a defensive move to a relief rally after the rate hike announcement. Investors will remain cautious since this is just the beginning of a rate hike cycle that will bring the fed funds rate to a neutral level. The Fed will take its cue from the behavior of inflation to achieve neutrality. Economists estimate a "neutral" position for the fed funds level would be between 4 and 5 percent and the Fed would move there by the end of 2005.

## Inflation is a key factor

Since the economy is growing at a healthier pace, investors will be watching for any signs of acceleration in inflation. The Fed might raise rates at a 'measured' pace if inflation is only 'transitory,' but a more persistent increase in prices could force the Fed to move aggressively in succeeding FOMC meetings.

The June headline CPI rose +0.3 percent which is slightly above the consensus estimate of 0.2 percent. The year-on-year headline CPI for June gained +3.3 percent from +3.1 percent in May. However, the core CPI ex-food and energy rose +0.1 percent below the +0.2 percent estimate. Even if inflation is still manageable, consumer prices have risen at a 2.9 percent annual rate in the first six months of 2004; faster than the 1.5 percent clip during the same period last year. In addition, the Philadelphia Fed survey of prices recorded a surge in producer prices in July, the highest since the 1980s. Businesses were raising their prices in July, with commodity prices showing no signs of moderation. These are catalysts for higher

*continued on page 3*

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## Notes from the July 16 advisory committee meeting

The LGIP Advisory Committee met July 16. A brief update was given on the net LGIP returns for March through June 2004 during which time the net rate remained fairly stable, averaging 1.025 percent. The fed funds rate during that time was 1 percent. Since the fed raised the targeted fed funds rate to 1.25 percent at its June meeting, the LGIP returns will also be increasing. The LGIP has outperformed its benchmark, iMoney.net, Inc., by an average of 43 basis points.

The strategy for the management of the LGIP portfolio was discussed. The portfolio has an average life of 37 days. The strategy is to keep short in anticipation of the next fed move which is expected to occur at the Aug. 10 FOMC meeting. Committee members discussed their investment strategies and the general market conditions.

A handout was distributed to committee members describing historical LGIP balance activity. The first chart showed month-end balances for Fiscal Year 2004. The second and third charts showed a comparison of the LGIP weekly balance activity for May to mid-July for 2003 and 2004.

A brief update was given on TM\$. A new option has been developed for making transfers between a participant's bond and primary accounts, which can be effective on the first of the month. This allows participants to clear out any remaining balance if an account has been closed. The LGIP administrator must be contacted in order to backdate the transfer so it will be cleared out on the first of the month. Sixty-seven percent of all transactions during

*continued on page 5*

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## Market Summary

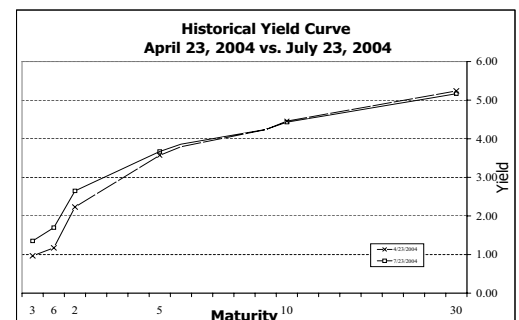
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inflation in the next few months. The Fed will keep a watchful eye on inflation numbers as a gauge to a 'measured' tightening. Investors still expect another 25 basis point rate hike in August.

Chairman Greenspan during his testimony before the Senate gave an upbeat assessment on the state of the U.S. economy. He said economic activity has quickened and the expansion become more broad-based. Inflation due to 'transitory factors' was the culprit for household income erosion, which softened consumer spending in June. He reiterated that the weaker economic numbers seen in June should prove short-lived. The FOMC predicted that the economy will grow between 4-4.75 percent this year. The unemployment rate was estimated to average 5.25 percent to 5.50 percent. The Fed's report also stated that the economy appears to have prepared itself for a more dynamic adjustment of interest rates.

### **LGIP returns to rise as Fed moves**

The net return on the LGIP during the second quarter of 2004 ranged from 1.019 percent to 1.031 percent. Throughout the first two quarters the LGIP maintained a neutral stance with regard to average life. With the recent Fed move, and threat of further rate hikes, expect to see the LGIP take on a shorter average life and more defensive stance in an effort to re-price as quickly as possible in response to those moves. Accordingly, LGIP participants can expect the LGIP returns to increase in a similar fashion as the targeted fed funds rate, but with a slight lag.



## Investing 101: Performance benchmarks 2 – A closer look

*The following article is part of the "Investing 101" educational series, which focuses on basic investment issues. We hope you find these articles informative and helpful.*

In our first article on performance benchmarks we discussed their value in assessing different aspects of an investment program. We suggested using one benchmark to measure the performance of the portfolio manager, and perhaps another to evaluate the overall effectiveness of the investment program. We also stressed the importance of carefully choosing an appropriate benchmark that matches the objectives and parameters of the portfolio being evaluated. In this article we'll look closer at some common benchmarks and discuss developing a customized performance benchmark.

To evaluate the effectiveness of your investment program you'll want to find a benchmark that indicates whether or not you are successfully meeting your program's goals and objectives; a relatively easy task. As an example, OST uses a benchmark for the state funds it manages to compare the value added of having an active investment program versus maintaining all cash in an overnight investment vehicle. As a similar benchmark, local governments might compare the performance of their investment program versus leaving all their funds in the LGIP or another short-term investment vehicle. These benchmarks are easy to track and to quantify the value added. However, because these types of benchmarks are not generally comparable to the entity's portfolio, particularly with regard to average life, it is not appropriate to evaluate program performance over short time periods (when rates are going up, a shorter portfolio will go up faster than a longer portfolio, and vice versa).

Finding an appropriate benchmark to measure the portfolio manager's performance is a more challenging task, because the benchmark should be an "apples to apples" comparison. Most benchmarks used in the private sector are measures of total return, which take into account unrealized gains or losses. However, since most government entities recognize and distribute accrued earnings and do not distribute unrealized gains or losses, private sector benchmarks would be unsuitable unless they are compared to the total return of the portfolio. Consequently, hypothetical portfolios represent the best benchmark for many public entities when it comes to evaluating portfolio manager performance.

A common and relatively easy benchmark to create and follow is a hypothetical ladder portfolio. For instance, you might monitor a hypothetical portfolio consisting of a ladder of 2-year U.S. Treasuries, which would be purchased every month at their auction yield. This portfolio would contain 24 securities and have an average life of one year. A longer ladder portfolio can be created using a longer maturity or by using a blended ladder. As an example, one of the benchmarks OST uses to evaluate fixed-income managers is a hypothetical ladder portfolio consisting of 2-year and 5-year U.S. Treasury securities. One could also include a shorter component to a blended ladder, like the 3-month Treasury Bill or the LGIP.

The goal for developing this type of benchmark is to create a hypothetical portfolio that comes as close as possible to reflecting a neutral position as set forth in your investment policy. That in mind, you would not want to select a benchmark with a two-year average life if two years is the maximum average life your policy allows. Creating a good benchmark is further complicated by the cyclical nature of the cash flows of most public entities. For those with strong cyclical cash flows a fairly large percentage of the balances must be invested in shorter maturities in order to be available to meet cash needs. However, the percentage of the portfolio that must be invested in shorter maturities may vary dramatically from month to month. In other words, the average life of the portfolio undergoes substantial changes that are not related to investment decisions, and thus should not be factored in the performance of the investment officer. This ever changing average life makes it somewhat difficult to create a meaningful benchmark.

There are two ways to deal with the problem of cyclical cash flows. One is to subdivide the portfolio into core and liquidity sub-portfolios; the core portfolio containing a more stable fixed income component, the liquidity portfolio handling all cash flow requirements. OST has done this with our state-managed funds and, while it is probably the most accurate way to eliminate cash flow variations from your performance measuring, it is also

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## Investing 101

*continued*

time-consuming and complex, because discretionary cash must be accounted for as well. Another option is to develop a benchmark with an average life that varies through time. An example might be a benchmark comprised of ladders of 3-month and 2-year U.S. Treasuries, where the percentage used of each ladder varies through time. During the low points in the cash flow cycle the benchmark yield may be weighted more heavily to the 2-year ladder (say 75 percent 2-year/25 percent 3-month) while during the high points in the cycle the benchmark yield may be more heavily weighted to the 3-month ladder (perhaps 25 percent 2-year/75 percent 3-month). This benchmark would have an average life ranging from 125 to 285 days.

Although finding or creating an appropriate benchmark to measure manager performance is not an easy task, it is an important one. For the benchmark to have any real value, it must closely reflect the portfolio it is used to evaluate. It is equally important that those with oversight authority know and understand the strengths and weaknesses of the benchmark to understand the reasons for any divergence in performance.

An appropriate performance benchmark is an important part of any investment program. The proper benchmark is a valuable tool for evaluating the performance of the program or the portfolio manager. The OST website ([www.tre.wa.gov](http://www.tre.wa.gov)) contains ladder and index information that might be useful in developing a benchmark. If you have questions or are interested in other benchmark data, please feel free to contact OST.

## Minutes

*from page 3*

the last quarter were made via TM\$, which represents an increase from the 62 percent seen during the previous quarter.

The FY 2004 budget was reviewed utilizing a handout provided to committee members. The average balance of the LGIP for FY 2004 was higher than original estimates. Accordingly, the fees collected were also higher, which combined with lower expenses have produced a larger rebate, now estimated at \$1.22 million. The rebate will be distributed to participants on Aug. 2.

The net fees for the fiscal year amounted to about 1.1 basis points. A chart was distributed to committee members showing the history of the LGIP participants' average investment balance and administrative expenses data for FY 1998 – FY 2004. It was also noted that administrative expenses have been lower the past three years due to the substantial savings in custody fees through the contract with The Bank of New York.

A brief review was given of the proposed LGIP Investment Policy, which had been mailed to advisory committee members for their review prior to the meeting. The main revision is clarification of the language regarding the maximum final maturity of floating or variable rate securities in Section VI, Investment

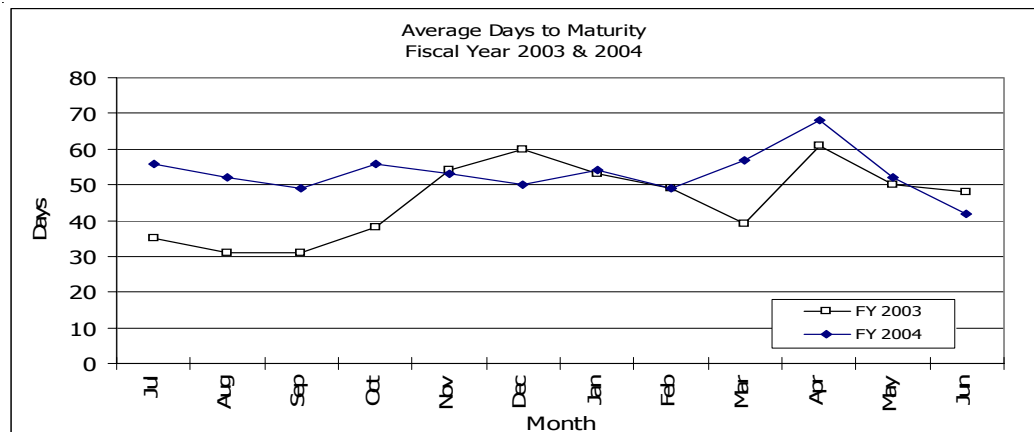
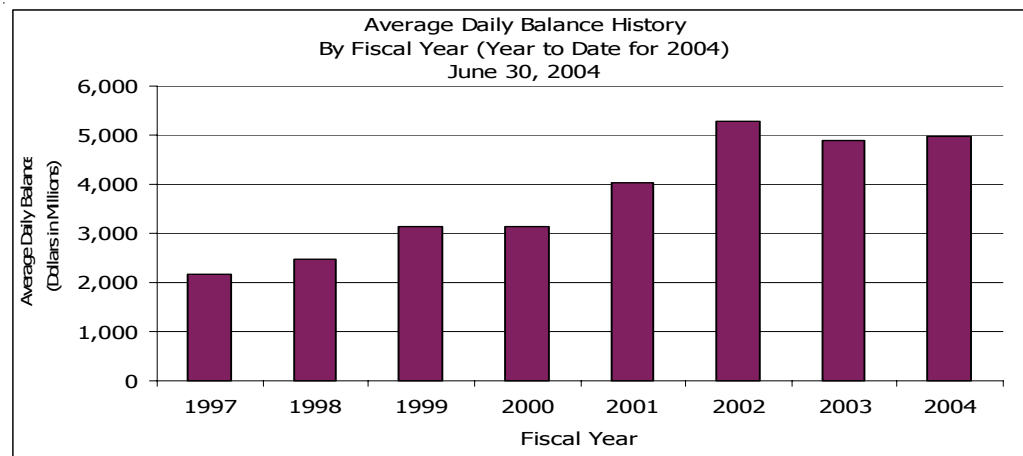
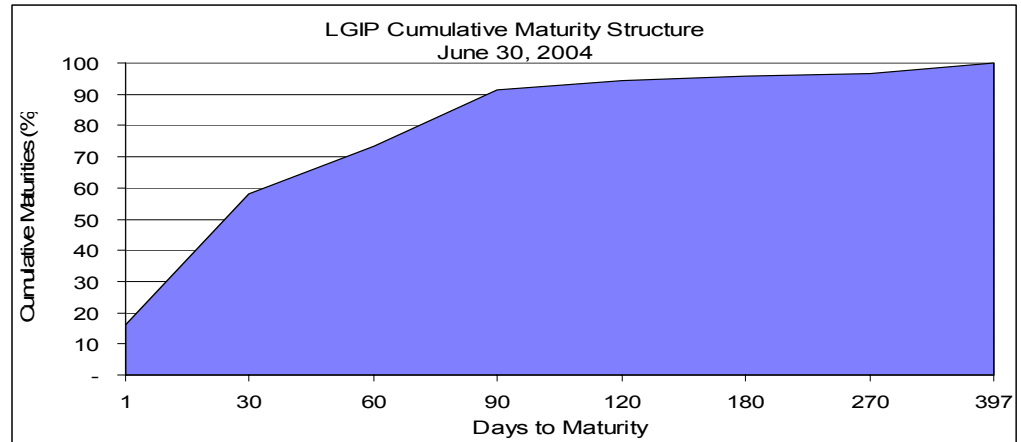
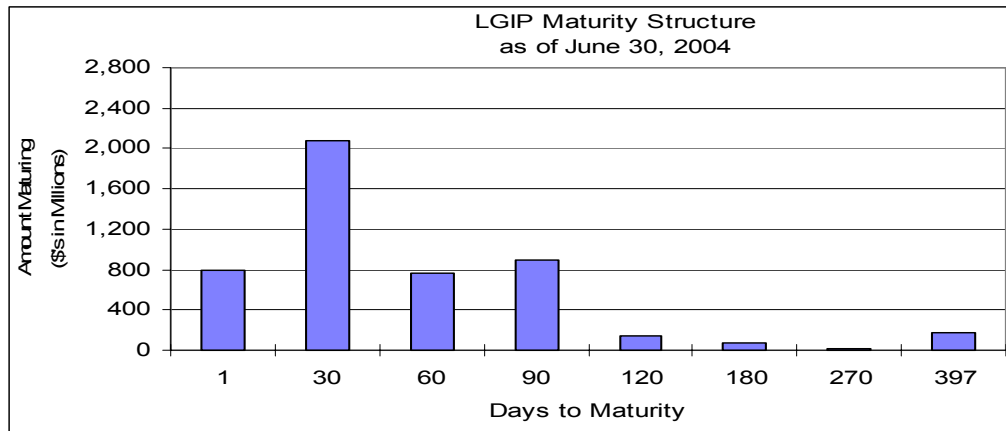
Restrictions. This allows the portfolio to be managed more effectively because OST can plan for increases in rates. A handout was distributed to committee members showing the proposed revisions, along with a copy of the final revisions to the investment policy, if approved.

A motion was made and seconded to recommend to Treasurer Murphy the approval of the LGIP Investment Policy revisions. Based on a unanimous recommendation, Treasurer Murphy approved the investment policy revisions.

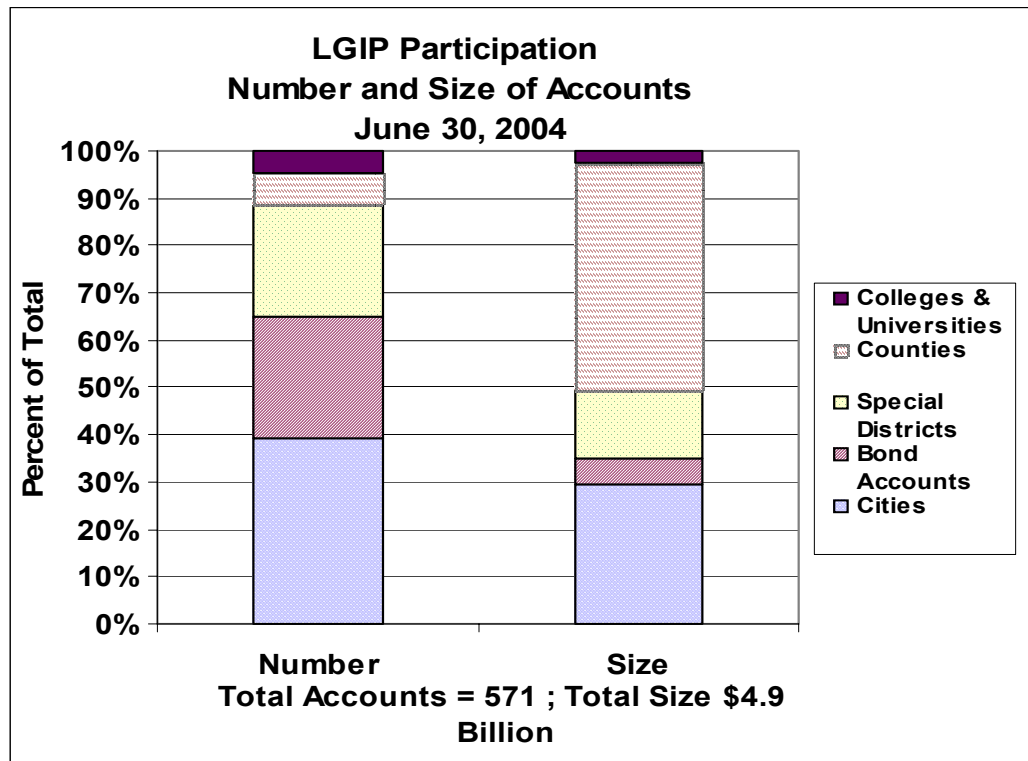
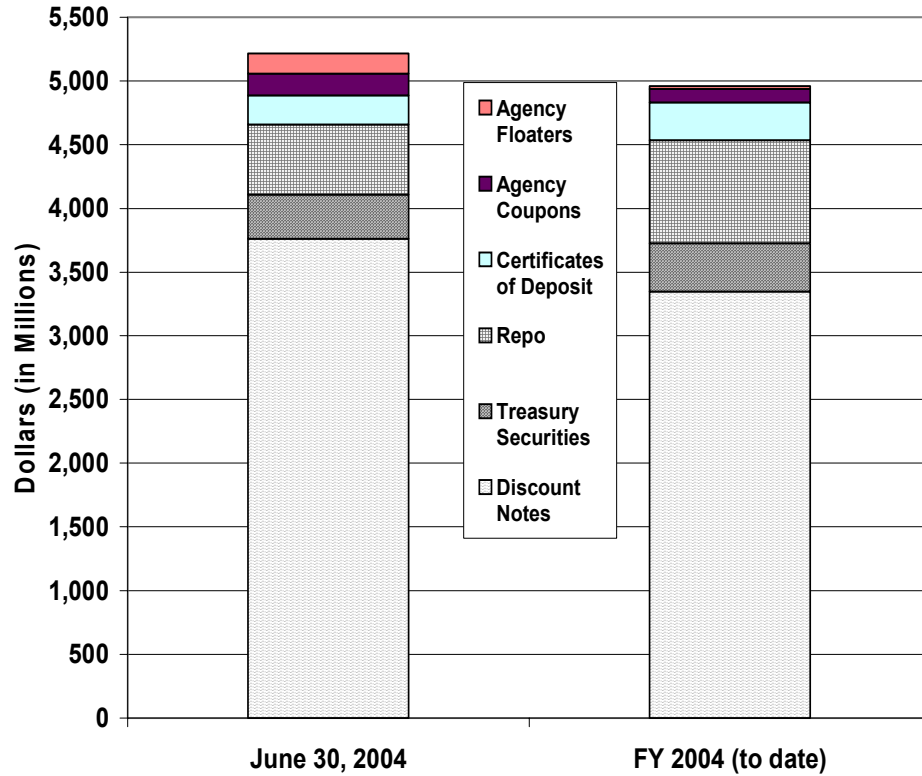
The external auditors, Peterson Sullivan PLLC, will be conducting their audit of the LGIP financial statements for FY 2004 beginning in August 2004.

### LGIP revises investment policy

At the July 16, 2004 LGIP Advisory Committee meeting Treasurer Murphy, based on a unanimous recommendation from members of the committee, approved proposed revisions to the LGIP Investment Policy. The revisions, which primarily deal with floating and variable rate notes, align the LGIP Investment Policy more closely with Rule 2a-7 guidelines, which the SEC uses to regulate the 2a-7 money market funds. You can view the revised policy on the OST web site at [www.tre.wa.gov](http://www.tre.wa.gov).



### Portfolio Composition Average Balance by Security Class



# From the LGIP Administrator’s Desk

By Jen Thun

## Clean out those bond accounts...

I’ve heard a few of you express that it is sometimes difficult to zero out your bond accounts – especially when you find you have three cents of interest in an account you thought you had closed. This happens when the first day of a new month falls on a weekend or holiday, preventing you from withdrawing or transferring the balance and previous month’s interest on the first. Even if you are able to zero out the account on the second or third, you will often earn some interest for those first few days. Likewise, if you withdraw the balance on the last day of a month, your earnings will generate interest over the weekend. This can be frustrating when you are trying to close a bond account.

Therefore, we can now backdate transfer transactions from your bond account to your primary account to the first of the month even if it falls on a weekend or holiday. This will help to prevent those pennies gained when you cannot close out your account on the first. If you use TM\$ you will still have to contact the LGIP Administrator to perform this transaction for you — participants cannot backdate a transaction, even transfers, before the current default date. If you would like to enter the transfer yourself, please do so, but be sure to contact the LGIP Administrator to set the date to the first. We hope you find this option useful in managing your bond accounts. This is one of the many developments that stems from participant comments. We value your comments and requests about the pool and strive to make it as beneficial as possible.

## TM\$ update...

Sixty-seven percent of all transactions during the last quarter were made via TM\$, which represents an increase from the 62 percent seen during the previous quarter. I have noticed a number of new users and new logon requests. We are glad to see interest in and use of TM\$ continue to grow.

If you have any questions or comments regarding the LGIP and TM\$, please feel free to contact me at 800-331-3284.

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## LGIP Holiday Schedule for 2004

The Local Government Investment Pool will be closed on the following days:

Monday	September 6	Labor Day
Monday	October 11	Columbus Day
Thursday	November 11	Veteran’s Day
Thurs/Fri	November 25-26	Thanksgiving holiday
Friday	December 24	Christmas
Friday	December 31	New Year’s



**Washington State Local Government Investment Pool**  
**Position and Compliance Report**  
**as of 6/30/2004**  
**(Settlement Date Basis)**  
(in Thousands)

**LGIP Portfolio Holdings**

	<b>Cost</b>	<b>Percentage of Portfolio</b>
U. S. Agencies	\$ 131,716	2.66
U. S. Callables	45,000	0.91
U.S. Agency Generic FRN	149,986	3.03
Certificate of Deposit	105,000	2.12
Discount Notes	3,436,611	69.52
Interest Bearing Bank Deposits	39,820	0.81
Repurchase Agreements	683,906	13.84
U.S. Treasuries	251,350	5.08
U.S. Treasury Bills	99,801	2.02
<b>*Total Excluding Securities Lending</b>	<b>4,943,190</b>	<b>100.00</b>

**Securities Lending Holdings**

Repurchase Agreements	298,799
<b>Total Securities Lending</b>	<b>298,799</b>

**Total Investments &**

**Certificates of Deposit**

\$	<u>5,241,989</u>
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**Policy Limitations**

The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.\*

**Size Limitations**

	<b>Portfolio Holdings</b>	<b>Percentage</b>	<b>Policy Percentage</b>
Agency Callables	45,000	0.91	10%
Certificate of Deposit	105,000	2.12	10%
Leverage - Sec Lend + Rev Repo	294,752	5.96	30%

**Maturity Limitations (Days)**

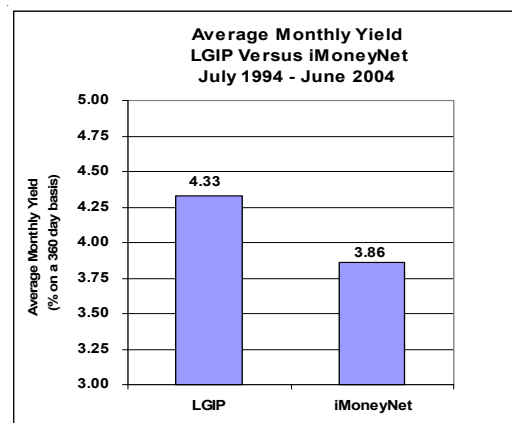
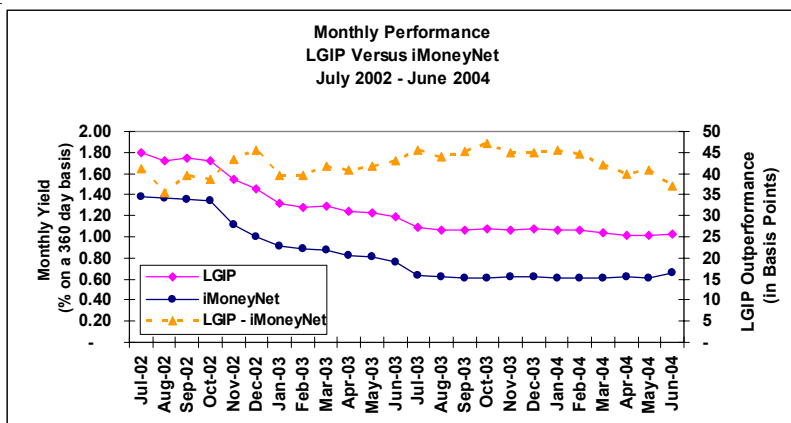
	<b>Currently</b>	<b>Policy</b>
Average Life	42	90
Maximum Maturity	365	397
Maximum Maturity of Repos	1	180
Maximum Maturity of Reverse Repos	0	90

**Repo Limits Per Dealer**

<u>Repo Limits Per Dealer</u>		Total Repo Percentage	Term Repo Percentage	Projected Redemptions	Projected Position
	June 30, 2004	(20% limit)	(10% limit)	7/1/2004	7/1/2004
Banc America Securities	\$ 350,000	7.08%	0.00%	350,000	0.00
Bear Stearns & Co.	109,576	2.22%	0.00%	109,576	0.00
Lehman Brothers Inc.	233,906	4.73%	0.00%	233,906	0.00
Merrill Lynch	100,000	2.02%	0.00%	100,000	0.00
Morgan Stanley Dean Witt	189,224	3.83%	0.00%	189,224	0.00
<b>Total</b>	<b>\$ 982,706</b>			<b>982,706</b>	<b>0.00</b>

# LGIP Performance Comparison

## iMoneyNet, Inc.<sup>1</sup> versus Local Government Investment Pool



The chart on the left shows a monthly comparison from July 2002 through June 2004 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to June 2004. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.8 basis points. This translates into the LGIP earning \$156.34 million over what the average comparable private money fund would have generated.

<sup>1</sup> Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

# Local Government Investment Pool

## STATEMENT OF NET ASSETS

June 30, 2004

(in Thousands)

### Assets

Investments, at Amortized Cost:		
Repurchase Agreements	\$	683,906
U.S. Agency Coupons		326,702
U.S. Agency Discount Notes		3,436,611
U.S. Treasury Securities		351,151

<b>Total Excluding Securities Lending &amp; Securities Purchased But Not Settled</b>		4,798,370
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Securities Lending Investments, at amortized cost:		
Repurchase Agreements		298,799
<b>Total Investments (Settlement Date Basis)</b>		5,097,169

Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:		
U.S. Agency Discount Notes		449,477
<b>Total Due from Brokers</b>		449,477
<b>Total Investments (Trade Date Basis)</b>		5,546,646

Interest Bearing Bank Deposits		39,820
Certificates of Deposit		105,000
Cash		.....
Interest Receivable		4,747
<b>Total Other Assets</b>		149,567
<b>Total Assets</b>		5,696,213

### Liabilities

Accrued Expenses		413
Obligations under Securities Lending Agreement		298,799
Investment Trades Pending Payable		449,477
<b>Total Liabilities</b>		748,689

<b>Net Assets</b>	\$	4,947,524
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Total Amortized Cost - Settlement Date Basis	\$	5,241,989
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## QUARTER AT A GLANCE

April 1, 2004 to June 30, 2004

(in Thousands)

Total investment purchases:	\$	31,914,985
Total investment sales:	\$	706,686
Total investment maturities:	\$	30,939,533
Total net income:	\$	14,310
Net of realized gains and losses:	\$	476
Net Portfolio yield (360-day basis):		
	April	1.0185%
	May	1.0169%
	June	1.0312%
Average weighted days to maturity:		42 days

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